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RUEHML/AMEMBASSY MANILA 1329
RUEHLO/AMEMBASSY LONDON 0108
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SUBJECT: Mongolia, Rio Tinto/Ivanhoe Reach Deal on Oyu Tolgoi Copper Mine

Ref: a) 05 Ulaanbaatar 0266; b) Ulaanbaatar 0119,

c) Ulaanbaatar 0123

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¶1. (SBU) SUMMARY AND COMMENT: Mongolia and Rio Tinto/Ivanhoe broke through a four-year long negotiating logjam to reach a deal which will allow development of the world class Oyu Tolgoi copper mine. To try to counter reflexive public criticism by opposition MPs and civil movement populists, and to help ensure the deal will receive the necessary parliamentary endorsement, the Government of Mongolia (GOM) underlined the economic advantages to Mongolia, including tax revenues which will amount to at least 13% of the country's current GDP. While details of the deal have yet to be fully revealed, both sides appear to have compromised. The GOM agreed to pay for its 34% equity stake with its share of the future profits from the mine, rather than its original request to receive the equity for free. Rio Tinto and partner Ivanhoe agreed to smelt the copper in Mongolia, rather than ship it out as concentrate, which avoided the government having to exempt the project from the Windfall Profits Tax on concentrate and also met the government's wish for more value added. GOM officials involved in the negotiations hope this will set a positive, useful precedent, and calm growing investor concerns about Mongolia's investment viability. END SUMMARY AND COMMENT.

¶2. (U) Ministry of Finance State Secretary Kh. Hurelbaatar announced in an April 10 press conference that the Government has Mongolia has reached an agreement with mining giant Rio Tinto and Ivanhoe Mines of Canada that will allow the western commercial firms to develop the world class copper-gold Oyu-Tolgoi (OT) deposit located in the South Gobi desert. The deal, or investment agreement as it is termed in Mongolian law, has not been fully publicized yet, but Khurelbaatar stated that outstanding details on state equity, the windfall profits tax, financing, and other developments at the OT had been settled. Under Mongolian law, the agreement will need

to be approved by Parliament.

¶3. (U) Khurelbaatar said that the Ministry of Finance estimates that over the life time of its operations the GOM will receive some US$15.5 billion in revenues or about US$340 million per year. By contrast, Ivanhoe has projected that government revenues would conservatively be some US$26 billion or nearly US$600 million/year for the 45-year life span of the mine. OT development costs are estimated at around US$2.1 billion dollars over the next three years, meaning that Rio-Ivanhoe FDI will raise the Mongolian GDP -- hovering around US$2.6 billion -- by some 25% year-on-year during development. (Ref A describes the development and refs B and C overview U.S. interests in Mongolia's mining potential.)

¶4. (SBU) The agreement followed four long years of often tortured, on and off again negotiations. Rio Tinto and Ivanhoe executives close to the negotiations had always told us that the key stumbling block had been the GOM's demand for an equity stake in OT, apparently without paying for it. Ivanhoe and RT have always held that the mine would not be commercially viable with a 34% free carry. For its part the GOM had painted itself into a corner by claiming that it would not pay for resources that already belonged to Mongolia, and could not face the public unless it could claim that it received some equity for free. A breakthrough in principle seems to have come last week when the Minister of Finance, in his capacity as acting Minister of Industry and Trade, told foreign and domestic miners that the GOM would pay for any equity share it chose to take under recently amended mining law of Mongolia. Compensation would be from: (a) state funds; (b) international financial markets; (c) tax exemptions.

¶5. (SBU) At the press conference, Khurelbaatar stated that the Mongolian Government would receive 34% of the "Oyu Tolgoi" project

free of charge and that RT-Ivanhoe will finance the project entirely. However, although vested in the project fully, the GOM will earn its share by deferring profits from its share. Based on available information, it seems as if the government has not exempted the mine from corporate taxes and royalty payments nor walked back from receiving a piece of the mine without paying anything up front, but it still has committed to paying for what it gets.

¶6. (SBU) The other detail that has come out is a work around for the Windfall Profits Tax (WPT), which caused major consternation among miners when it was abruptly enacted in May 2006. Rio-Ivanhoe had always told emboffs that a 68% tax on copper profits for copper concentrate for all copper over US$2600 per metric ton imperiled OT's commercial viability. The GOM's position -- based on a clear and consistently expressed desire adding value in Mongolia -- was to note that the WPT does not apply to smelted ore. RT-Ivanhoe had always held that smelting in Mongolia would not be commercially viable. The GOM and several other mining industry experts questioned this position, wondering why it would be cheaper to ship out huge amounts of copper concentrate with its high percentage of money-loosing dross than it would be to send out value-added cathode or even copper wire or other copper products.

¶7. (U) Rio-Ivanhoe has acceded to the GOM's policy in this area to get its WPT waiver. Under the agreement, the company has apparently agreed that from initial operations projected to begin in 2010 and run till 2055, that it will smelt copper from open pit and shaft operations at a mine-mouth, state of the art smelter. Such a decision will require development of energy, road, rail, and other related developments to service the mine and ore concentration and smelting facilities.

¶8. (U) Post will continue to monitor and report on details of this pivotal agreement as they unfold.

Goldbeck